September 7, 2004

David Ikari, Branch Chief
Dairy Marketing
California Department of Food and Agriculture
1220 N Street
Sacramento, California 95814

Dear Mr. Ikari:

Land O' Lakes petitions the Department to hold a hearing on the Class 4b pricing formula.

The California Department of Food and Agriculture completed a cost analysis on butter, powder and cheese plants and has published the findings. They have just recently completed a cost of processing whey in cheese plants in California and these findings have also been published. Based upon those studies, Land O' Lakes proposes changing the Class 4b formula to take into account the study on the difference between the CME price and the California weighted average prices received by 5 cheddar plants over time and the Class 4b formula should also take into account the most recent cost studies published by CDFA and the study on the cost for processing whey. Land O' Lakes recommends that these numbers be reflected in the Class 4b formula in California. CDFA did not have cost numbers for processing whey in the last make allowance hearing and we feel that it is essential to reflect the findings of the recent studies on cost of manufacturing whey in California.

There is considerable volatility in the difference between the CME price and the weighted average prices received by California cheese plants. Because of this volatility, we would urge the use of a 36 month average rather than 24 month average as reflected in the document called CME Cheddar Cheese Prices vs. California Cheddar Cheese Sales.

In addition, from the standpoint of costs, we urge the CDFA to make an energy and labor cost update to reflect recent changes in energy and labor costs in manufacturing plants in California. This energy and labor update should be used as a basis for amending the make allowances for butter, powder and cheese.

The inclusion of whey in the Class 4b formula was premature. The Department of Food and Agriculture simply had no information about the costs of processing whey. It turns out that the weighted average cost of processing whey was .2675 per pound. The current formula reflects a make allowance of only 17 cents per pound. The Cost by CDFA revealed there was not a single plant with costs as low as 17 cents per pound. This formula has been extremely costly to Class 4b plants in California, especially for months where the whey price exceeded 17 cents. In fact, one can assume that whenever whey prices exceeded 17 cents every single plant included in the cost study experienced a loss in the whey operation. The reason is that the CDFA used a 17 cent make allowance

when the make allowance should have been $.2675 per pound. Now that whey is included in the formula we recommend that the whey make allowance be increased from 17 cents per pound to 26.75 cents per pound to reflect the weighted average costs involved in processing whey.

Land O' Lakes recommends that CDFA adjust the make allowance and the freight factor to reflect the CDFA cost studies. But, the make allowance should reflect an update on energy and labor costs. The formal proposal would be as follows:

	Make allowance	California price less CME
Butter		
Current formula	.132	.0332
Proposed	.1235	.0329
Powder		
Current formula	.15	na
Proposed	.1494	na
Cheese		
Current formula	.175	.0321
Proposed	.1632	.0277
Whey		
Current formula	.17	na
Proposed	.2675	na

Again, we recommend an energy and labor cost update for butter, powder and cheese operations and those changes should be reflected in the weighed average costs and should then be used as a basis for the make allowance.

Cheese Yield. Our position has always been to reflect the cheese yield for the typical milk supply. Our proposal is that CDFA re-establish a cheese yield of 10 with the fat component at 3.65 and the solids-not -fat component at 8.78. The 3.65 and the 8.78 reflects the typical average fat and solids-not-fat for the California milk supply. A cheese yield of 10 would be a very reasonable cheese yield taking into account the fat and the typical casein one would find in the California milk supply.

Dr. Phil Tong of Cal Poly University in his milk component study summarized information on fat, protein and casein as a percent of protein in cheese plants, in butter-powder operations and in fluid milk plants. The fat, protein and casein as percent of protein for cheese plants is not very useful because of the use of yield premium programs by some major cheese operations in California that encourage producers to enhance the

fat and protein content in their milk supply through breed selection, feeding programs and the like. This milk does not represent the "typical" milk supply in California. It is useful to observe the milk components that is processed into butter and powder. The average fat test in the Tong survey was 3.63 percent; the solids not fat percent was 8.8 percent and the percent of casein in solids not fat was .2832. The average moisture content in cheddar operations is between 37 and 38 percent. The following illustrates the cheese yield using the Van Slyke Formula:

(((.92 x 3.63)+(.2832 x 8.8)-.1)*1.09)/(1-.3778) = 10.04

The conclusion is that the yield that CDFA had used prior to April 1, 2003 was very realistic for the typical milk in California. It is our opinion that CDFA use a cheese yield of 10 with a fat component of 3.65 and and solids not fat component of 8.78. By the way a fat retention of 92 percent is considered aggressive.

It is extremely important for CDFA to provide price relief to cheese plants in California. The California milk supply continues to grow. In fact, the California Milk Advisory Board Study predicts that by 2012 there will be about 12.2 billion pounds of additional milk in California. The cost of a new cheese operation with about 6 million pounds of milk per day is about $200 million. This is an extremely high investment cost and the risks are huge. The start-up costs are very high and it takes a considerable period before a cheese operation is able to make cheese that is satisfactory to the customer. Furthermore, a new cheese operation in California has to compete with cheese operations in other parts of the country. This past year there was a very high incidence of de-pooling on the part of cheese operations in Federal order markets. What does this mean? It means that those firms are able to retain those high cheese milk prices within their own organizations rather than to share those proceeds with other producers in the industry. This, of course, provides those federal order operations with a distinct competitive advantage over California cheese operations where pooling is mandated.

The cost study on whey illustrates that the California cheese operations paid too much for milk going into cheese from April 2003 through August 2004. It is extremely important that CDFA make the appropriate formula adjustments to reflect the real costs associated with cheese operations. If that is done, then the California firms are in a better position to invest in new cheese operations to accommodate the growth in milk production in California. The cheese operations in California will also be more able to compete against Federal order cheese operations that have the capability of de-pooling when the Class III prices exceed the Federal order blend prices.

We urge the Secretary to call a hearing on Class 4a and 4b pricing formulas as soon as possible.

Thank you for your consideration.

Sincerely,

James W. Gruebele
Consultant for Land O' Lakes

CC: Kelly Krug
John Lee